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Revenue Interim Committee

67th Montana Legislature

TO: Committee Members

FROM: Jaret Coles, Staff Attorney

RE: Constitutional Initiative No. 121 – Legal Considerations for Implementation

DATE: April 14, 2022

This memorandum provides an overview of provisions of the federal and Montana constitutions that are frequently used to determine the constitutionality of state taxation. Additionally, the provisions are analyzed in relation to Constitutional Initiative No. 121 (CI-121), which has been discussed in this committee. Before I provide you with my opinion and analysis, a few caveats are necessary. Due to the constitutional constraints inherent in the separate powers of each branch of state government, a legal opinion provided to you by a Legislative Branch attorney is obviously not binding on the Executive Branch.

CI-121 would amend Article VIII, section 3, of the Montana Constitution to limit annual increases and decreases in valuations of residential property to the lower of 2% or the inflation rate if the property is not newly constructed, significantly improved, or had a change of ownership since January 1, 2019, and limit total ad valorem property taxes on residential property to 1% or less of the assessed valuation. This amendment would implement a system that is like an acquisition[1] value for residential property as opposed to a market value system.

The Montana Constitution establishes the limits on legislative authority for legislative action. The general rule is that the Constitution is a limit and not a grant of legislative authority. *State ex rel. Evans v. Stewart*, 53 Mont. 18, 161 P. 309 (1916). As such, if CI-121 is enacted, the Legislature will need to implement the provision while conforming to other federal and state constitutional provisions.

The amendments in CI-121 are underlined for reference, while existing constitutional language is not underlined:

> **Section 3. Property tax administration -- limitation.** (1) ~~The~~ Subject to this section, the state shall appraise, assess, and equalize the valuation of all property which is to be taxed in the manner provided by law.
>
> (2) Except as provided in this section, the assessed valuation of residential property shall be the amount determined by the state in 2019.

[1] The proposed amendment is not technically an acquisition value approach since the starting point is market value on a particular date. An acquisition value approach would fix the value at purchase price, while CI-121 fixes the value based on market value on a particular date (subject to maximum statutory increases). Given the fact that yearly increases are based on a statutory formula and not the market, the system is closely related to an acquisition approach, and this memorandum uses the term acquisition value throughout to distinguish the two approaches.

(3) The value of residential property may be reassessed annually on January 1 of each year. If residential property is not newly constructed or significantly improved or did not have a change of ownership since January 1, 2019, the change in revised assessed valuation for a year may not exceed the lower of the following:

(a) two percent of the valuation for the prior year; or

(b) the percent change in the consumer price index, U.S. city average, all urban consumers, using the 1982-84 base of 100, as published by the bureau of labor statistics of the United States department of labor.

(4) After January 1, 2019, whenever residential property is newly constructed or significantly improved or has a change of ownership, it must be assessed by the state at its fair market value with subsequent changes to that assessment made in accordance with the limits in subsections (3)(a), (3)(b), and this subsection (4).

(5) The legislature shall limit the total amount of ad valorem taxes assessed against residential property and such limit shall not exceed one percent of the valuation established by this section.

(6) The legislature shall define "residential property" and provide for the application and implementation of subsections (2) through (5), and it may provide for acquisition valuation of other real property.

History of Article VIII, section 3, of the Montana Constitution

Article VIII, section 3, of the Montana Constitution has been the crux of the property tax system in Montana and has been the subject of most of the litigation concerning property taxes. The 1972 Montana Constitution revised Article XII, section 15, of the 1889 Montana Constitution by removing references to county boards of equalization and the state board of equalization. These changes left the Legislature free to determine the method of securing property tax administration. Chapter 405, Laws of 1973, transferred the powers and duties of the State Board of Equalization to the Department of Revenue and the State Tax Appeal Board. In *Department of Revenue v. Burlington Northern, Inc.*, 169 Mont. 202, 545 P.2d 1083 (1976), the Montana Supreme Court held that the State Board of Equalization's administrative functions were transferred to the Department of Revenue, while the appellate functions were transferred to the State Tax Appeal Board.

Article VIII, section 3, of the Montana Constitution has several component parts under current law. The first requirement imposes a duty on the state to administer the property tax system. This change of duty was referred to in the statement of intent attached to Chapter 27, Special Laws of 1993. It stated that with the adoption of the 1972 Montana Constitution, the state assumed responsibility for the appraisal, assessment, and valuation of property for property tax administration. Although the state was granted this new responsibility and authority by the Constitution, county assessors were retained by local governments to assist the state in the assessment function, acting as agents of the Department of Revenue. After the enactment of Chapter 27, Special Laws of 1993, all appraisal and assessment duties relating to property taxation were assigned to the Department of Revenue. The responsibility and authority to perform any assessment functions were transferred from the county assessors to the Department of Revenue.

The second requirement of this section is that the state appraise property subject to taxation. Appraisal is the setting of a value for property tax purposes. The appraisal of property is governed by Title 15, chapter 7, MCA. The third requirement of this section is that the state assess property subject to taxation. Assessment is the setting of the estimated value of property for purposes of taxation and the setting of the amount of a tax. The assessment of property is governed by Title 15, chapter 8, MCA. The fourth requirement of this section is that the state equalize the valuation of property subject to taxation. These requirements have been the major areas of contention in the property tax arena.

There has been a great deal of litigation over the requirements of this section under current law. Based on the analysis of the cited decisions, Article VIII, section 3, of the Montana Constitution simply requires the state to uniformly administer a method of valuing similar property so that equal valuation is achieved. In *Department of Revenue v. State Tax Appeal Board*,188 Mont. 244, 613 P.2d 691 (1980), the Montana

Supreme Court held that when it is impossible to secure both the standard of the true value of a taxpayer's property and the uniformity and equality in taxation required by law, the latter requirement is to be preferred as the just and ultimate purpose of the law. Therefore, under current law, unequal appraisals may be reduced even though they were an assessment at true market value or 100% of market value as required by 15-8-111, MCA. Reduction in valuation is required when it is satisfactorily shown that, under the system as applied, it is impossible to meet both the true value and equality standards. In the event CI-121 passes, Montana will switch from a system that is based on equal valuation to a system based on acquisition value for residential property. Given the shift, existing case law under Article VIII, section 3, of the Montana Constitution regarding equalization would be largely irrelevant unless used to resolve disputes regarding nonresidential property. Indeed, the proposed amendments treat taxpayers differently based on when a property was acquired. The next section provides an overview of equal protection in regard to an acquisition value system.

Equal Protection in General

In addition to the provisions of Article VIII of the Montana Constitution, the equal protection clause contained in Article II, section 4, of the Montana Constitution and the due process clause contained in Article II, section 17, of the Montana Constitution also apply to property taxation. The equal protection clause essentially requires that similarly situated individuals and entities be treated in the same manner. In the area of taxation, the Legislature is required to have a rational basis for its action. *Montana Stockgrowers Association v. State*, 238 Mont. 113, 777 P.2d 285 (1989), followed in *GBN, Inc. v. Department of Revenue*, 249 Mont. 261, 815 P.2d 595 (1991).

A taxpayer whose property value decreased as a result of the 1997 reappraisal filed suit over the 2% phasein of changes of property values set forth in former 15-1-111(1), MCA. Taxpayers who had an increase in property values because of reappraisal had the effects of the increase mitigated because of the 2% annual phasein, but taxpayers suffering a decrease in property value just realized a phased-in portion of the decrease. In *Roosevelt v. Department of Revenue*, 1999 MT 30, 293 Mont. 240, 975 P.2d 295 (1999), the Montana Supreme Court held that creating a class of property owners whose taxes are assessed on a basis greater than the market values of their property while other property owners are assessed property taxes based on the actual or less than actual value of the property causes the property owners in the first class to "bear a disproportionate share of [Montana's] tax burden" in violation of equal protection under the Montana Constitution (quoting from *Department of Revenue v. Barron,* 245 Mont. 100, 799 P.2d 533 (1990)). The Court said that there was no rational basis for the state to impose property taxes in that manner. The Court declared that former 15-1-111(1), MCA, as applied to this taxpayer, was unconstitutional and that the taxpayer was entitled to be assessed at the actual 1997 market value of the property. The Court specifically declined to rule on the constitutionality relating to the class of property owners who are paying taxes based on the market value of their property (those whose value did not change because of reappraisal) and the class of taxpayers who were paying property taxes based on less than the actual value of their property (those whose value was being phased in to the 1997 value at 2% a year). Both the decision and dissent addressed the problems of equality of valuation in tax treatment, but it was noted that if the equality is corrected within a reasonable time, no constitutional harm occurred.

In 2002, an equal protection analysis was applied to vocational-technical school levies. Plaintiffs challenged the constitutionality of 20-25-439, MCA, asserting that the tax levy for vocational-technical schools resulted in an unequal tax burden on five counties where the schools are located, even though the schools are part of the statewide University System. The state contended that the levy is not unconstitutional because it is rationally related to a legitimate government purpose. The District Court found that the levy is constitutional because it is rationally related to the legitimate government interest of supporting the schools, in that the schools provide specific benefits to their individual counties. The Montana Supreme Court agreed that the rational basis analysis applied. The constitutional tax provisions in Article VIII, sections 1 and 3, of the Montana Constitution are broad directives whose specifics are left to the Legislature, so no constitutionally significant interests are implicated that require greater than a rational basis analysis. A tax classification under the rational basis test will be upheld if it is reasonable and not arbitrary and if it applies equally to all who fall within the same classification. A classification is not

reasonable if it confers particular privileges or imposes particular disabilities on a class of persons arbitrarily selected from a larger number of persons, all of whom stand in the same relation to privileges conferred or disabilities imposed. Neither the uniformity doctrine nor equal protection prevents the state from making classifications that result in different state taxes among the various counties as long as the classifications are rationally related to a legitimate government purpose. Simply because other state taxes for education funding are assessed in every county does not mean that the Legislature is prohibited from creating subclasses for tax purposes. Attendance at vocational-technical schools by local residents and course offerings related to local interests serve as a rational basis for putting the five counties in a separate class for purposes of the levy. Counties with vocational-technical schools are not arbitrarily selected from the rest of the state because those counties do not stand in the same relation to the greater privileges conferred on those counties by the schools than the rest of the state, so the disability of the levy is rationally imposed. The constitutionality of 20-25-439, MCA, was affirmed. *Kottel v. State*, 2002 MT 278, 312 Mont. 387, 60 P.3d 403 (2002).

- *CI-121 Applied -- Equal Protection*

The *Roosevelt* decision is distinguishable when applied toward CI-121, despite the disparate treatment among taxpayers. Unlike *Roosevelt,* which pertained to a statutory amendment, CI-121 amends the text of the Montana Constitution to permit an acquisition-based system. In *Nordlinger v. Hahn*, 505 U.S. 1 (1992), the United States Supreme Court considered an equal protection argument that California's constitutional requirement that real property be taxed at its "acquisition value" rather than its current market value unfairly discriminated against recent property purchasers in favor of those owning similar pieces of property that had been purchased years earlier at a lower price. *Nordlinger,* 505 U.S. at 12. The United States Supreme Court held that California had demonstrated at least two rational bases for its "acquisition value" system of taxation. First, California had "a legitimate interest in local neighborhood preservation, continuity, and stability." *Id.* Second, California concluded "that a new owner at the time of acquiring his property does not have the same reliance interest warranting protection against higher taxes as does an existing owner." *Id.* Given the United States Supreme Court's holding in *Nordlinger,* the proposed acquisition-based system of property tax should pass constitutional muster if challenged under an equal protection argument.

In the event CI-121 is passed by the electorate, the Legislature will be permitted to implement the amendments so long as the legislation is reasonable and not arbitrary and if it applies equally to all who fall within the same classification. This would include determining which property qualifies as "residential property" and whether other classes of property are subject to a market value approach or an acquisition value approach.

Classes of Property in General

The Legislature has classified property for purposes of taxation. Statutes that provided for the classification of property for purposes of taxation did not infringe on the guarantee of the equal protection of the laws. *Hilger v. Moor*e, 56 Mont. 146, 182 P. 477 (1919). The Legislature may properly go even to the extent of placing identical articles in the hands of different owners in different classes, because different uses result in different productivity. A classification will be upheld if it has a reasonable relation to some permitted end of governmental action. *Wheir v. Dye*, 105 Mont. 347, 73 P.2d 209 (1937). However, when a classification results in discrimination, it is an unconstitutional exercise of the legislative function to classify property for taxation. *Victor Chemical Works v. Silver Bow County*, 130 Mont. 308, 301 P.2d 730 (1956).

Despite the Legislature's broad authority over classification, it is most likely a violation of equal protection provisions of the Montana Constitution to levy different mill levy rates on different classes of property within a jurisdiction.[2] Article XII, section 1, of the 1889 Montana Constitution required that property taxes

[2] For further analysis regarding this issue, see a staff attorney memorandum by Lee Heiman, Montana Legislative Services Division, Levying Different Property Tax Mills Against Different Classes of Property, Dec. 6, 2007.

be levied under "a uniform rate of assessment and taxation," and Article XII, section 11, of the 1889 Montana Constitution required that taxes be levied and collected by general laws and in a manner that was "uniform upon the same class of subjects within the territorial limits of the authority levying the tax." These two provisions became known as the "uniformity" provisions. In *Hilger v. Moore*, 56 Mont. 146, 182 P. 477 (1919), the Montana Supreme Court held that the uniformity of assessment was by class of property based on the proportion of the property's "use, its productivity, its utility, [and] its general setting in the economic organization of society" (56 Mont. at 173). Property may be valued differently in different classes to recognize the different characteristics of the property. Other states with uniformity provisions have interpreted their provisions to disallow classes and require that all property be uniformly taxed based on its market value and then taxed uniformly by each taxing jurisdiction with the same mill levy.

The revenue provisions in the Montana Constitution adopted in 1972 did not contain any uniformity language. The delegates excluded uniformity clauses and specifically recognized that the uniformity of taxation was required by the equal protection clause of the United States Constitution. See Verbatim Transcript Vol. II, pp. 579, 580, 582.

In *Powder River County v. State*, 2002 MT 259, 312 Mont. 198, 60 P.3d 357, the Montana Supreme Court specifically discussed the uniformity clauses of the 1889 Montana Constitution and how uniformity was to be applied under the 1972 Montana Constitution. At issue was a challenge to the legality of the Legislature's changes to the way oil, gas, and coal were taxed as enacted in the 1989 and 1995 sessions. The new form of taxation was no longer property tax based. Oil, gas, and coal were separately taxed, and the revenue was distributed to the state, local governments, and schools based on formulas. The Court specifically stated that the uniformity principle established in *Hilger* was still the law in Montana.

In other words, in order to secure a just valuation of all property, the method of assessing value must be uniform, and, subsequently, after the property has been justly valued via a uniform method, property within the same class must be uniformly taxed—that is, taxed at the same percentage. *Id.* ¶ 52 (citing *Hilger,* 56 Mont. at 170, 182 P. at 481-82).

Uniformity allows classification to reflect the character of the property and thus allows different taxes for each dollar of value of the taxed property. Uniformity does not allow different levies against different classes of property. The number of mills levied is based on a political decision of the taxing entity with regard to all taxable property within the entity's jurisdiction.

- *CI-121 Applied -- Uniformity, Equal Protection, and Due Process*

In the event CI-121 is passed by the electorate, the Legislature may be tasked with determining whether to generate revenue that was available under the old system that is not available under the new system. One method that has been discussed during the interim is whether the Legislature could enact property tax legislation that permits a levy of different mills against residential taxpayers that are not subject to the CI-121 cap. For example, if residential taxpayers in a municipality are taxed at 1% of value because of the cap but residential taxpayers next to the municipality (*i.e.,* rural taxpayers) are not taxed at 1% of value, can the tax burden be shifted to the rural taxpayers to make up the difference? It is hard to predict how the Montana Supreme Court would rule on this issue, but one could speculate that shifting mills to rural taxpayers is a violation of uniformity of rates as well as equal protection and due process. This would create different levels of taxation based solely on whether a rural taxpayer is located near a municipality that has exceeded mill authority. A nearly identical rural taxpayer in a different part of the state that does not neighbor a municipality that is subject to the cap would not be required to pay an additional share of tax, which would create an equal protection issue. Substantive due process is also implicated. A statute "must be reasonably related to a permissible legislative objective in order to satisfy guarantees of substantive due process." *Montana Cannabis Industry Association v. State*, 2016 MT 44, ¶ 21, 382 Mont. 256, 368 P.3d 1131. Allowing residential taxpayers of a municipality to vote for additional levies that will be passed on to the rural taxpayers may not be a reasonable means to accomplish the objective of raising revenue. *See id.* (reasoning the means chosen by the Legislature to accomplish its objective must be reasonably related to the result sought to be attained).

In addition to the potential issues associated with shifting mills to another taxing jurisdiction, there has been discussion during the interim regarding whether the Legislature could increase mills for nonresidential taxpayers in a jurisdiction that is subject to the cap. This proposal would not create uniformity of rates. Moreover, there is a due process argument that it is unfair to permit residential taxpayers to vote for increased mill levies that will not be directly passed on to the residential taxpayers. Ultimately, there are several legal arguments against shifting mills. Any legislation that permits the shifting of mills will need to be thoroughly analyzed.

State Residence of Taxpayer

Another area of constitutional concern is the treatment of nonresidents. Use of residency to classify persons is a matter of federal law under the United States Constitution. Classification based on residency is prohibited by the privileges and immunities clause contained in Article IV, section 2, of the United States Constitution. The United States Supreme Court in *Austin v. New Hampshire*, 420 U.S. 656, 43 L. Ed. 2d 530, 95 S. Ct. 1191 (1975), said that although the privileges and immunities clause does not guarantee precise equality of taxation between residents and nonresidents, the practical operation and effect of the tax must be examined, and a substantial equality of treatment of residents and nonresidents is required. Often discussed in privileges and immunities tax cases is the history of the clause: it was adopted because under the Articles of Confederation, each state was a taxing island imposing taxes on nonresidents in preference to residents. The other underlying theme behind prohibiting the use of state residency as a tax classification is that of representative democracy. Nonresidents are not represented in state legislatures, and thus there is no political check on taxation of them. Of course, a nonresident is subject to the same taxes as a resident, and unless the taxation is transparently aimed at nonresidents, the tax revenue from nonresidents can be more than that collected against residents.

A twist on the privileges and immunities clause is the "fundamental rights" test set out in *Baldwin v. Fish and Game Commission of Montana*, 436 U.S. 371, 56 L. Ed. 2d 354, 98 S. Ct. 1852 (1978). The United States Supreme Court upheld Montana's imposition of a nonresident hunting license fee that was 7.5 times as much as a resident license. The Court held that hunting was a recreational activity that simply did not come within the purview of the protection of fundamental rights protected by the privileges and immunities clause. The Court did not provide any test for determining what those fundamental rights might be, but it did include the right not to be deprived of a livelihood. How this doctrine extends to taxation has not been determined.

Often the matter of residence is a question of equal protection guarantees under the 14th amendment to the United States Constitution. For tax questions under the United States Constitution, in most cases, the courts use the "rational basis" test similar to that test under the Montana Constitution. For tax classifications based on fundamental constitutional rights, a "compelling state interest" test is employed. Under the federal equal protection clause, fundamental rights are those rights explicitly or implicitly guaranteed by the United States Constitution and include the right to vote, the right to engage in interstate travel, and the right to speak. (See *Dunn v. Blumstein*, 405 U.S. 330, 31 L. Ed. 2d 274, 92 S. Ct. 995 (1972).) The right to travel and possibly the rights guaranteed by the privileges and immunities clause could be fundamental rights that the state could not use as tax classifications without a "compelling state interest."

- *CI-121 Applied -- Definition of Residential Property -- Privileges and Immunities Clause*

In the event CI-121 is passed by the electorate, the Legislature would be required to define "residential property." In doing so, the Legislature will have some flexibility in determining what property is subject to the acquisition value approach. This may or may not include rental property, recreational property, and second homes. Under current law residential property is classified as class four property, which includes single-family residences, trailers, manufactured homes, mobile homes used as a residence, improvements to residences, parcels of land where residences are located, vacant residential lots, rental multifamily dwelling units, and commercial property. *See* 15-6-134, MCA. Additionally, there are variable rates of taxation between residential, commercial, and residential property that exceed $1.5 million in value. Given the current classification of class four property, the Legislature would need to determine

whether to develop another classification or amend the structure of class four property to comply with CI-121.

In crafting a definition of "residential property" the Legislature is not permitted to tax residents more favorably than nonresidents. However, the Legislature can determine whether an individual needs to occupy property for a certain percentage of time for the property to be declared "residential property." For example, defining "residential property" as property that is occupied for at least 7 months would be permissible under the privileges and immunities clause even though it would have a negative impact on nonresidents. This is the case since the restriction applies equally to all taxpayers regardless of residency. *See* 15-6-301(4), MCA (providing a definition of "primary residence").